Twenty Challenging Gift Annuity Questions

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This paper presupposes that the reader has a basic understanding of gift annuities. Rather than traversing familiar territory, it addresses more difficult and intriguing questions that have been posed to the author by those who operate gift annuity programs.

Some questions concern technical issues, others pertain to the tax consequences when complicated assets are contributed for a gift annuity, and still others involve programmatic matters. In some instances, the answers are quite clear, but in other cases there is a degree of uncertainty because of the absence of legislation, regulations, and rulings specifically on point. The objective is to offer some pragmatic, practical suggestions that will be of value when confronted with the challenge of operating a gift annuity program and dealing with the complex issues that inevitably arise.

1. Can payments from a gift annuity be made to a trust where the trustee is empowered to make discretionary payments to the individual for whom the annuity was established? If so, who pays the income tax due on the payments?

A charitable remainder trust with a term measured by the life of an individual can make payments only to that individual, subject to the limited exception of payments to a trust for a beneficiary lacking capacity. However, there is nothing comparable in the rules governing gift annuities. Therefore, it can reasonably be concluded that a gift annuity for the life of an individual could be paid to a trust for that individual.

The trust will include in its income the taxable portion of the annuity payments, but it will get a deduction for the distribution it makes to the individual beneficiary under the normal rules of IRC Sec. 662 that apply to complex trusts. That individual would then be taxed on the distributions. In the event the donor has a legal obligation to support the beneficiary, then the donor could be treated as the owner of the trust under the grantor trust rules, IRC Secs. 671-679, and would be taxed on the income.

Another question arises if the gift annuity is deferred. That is whether tax will be payable on the increasing value of the annuity during the deferral period. The normal rule in IRC Sec. 72 (u)(1) is that the build-up is taxable if the annuitant is not a natural person. The trust is not a natural person; however, this Code Section provides an exception to the normal rule when the trust is an agent for a natural person. The income also is not taxed if the gift annuity is immediate, which is defined in IRC Sec. 72(u)(4) as an annuity purchased with a single premium with a starting date no later than one year from the date of purchase.

2. Can a company establish a gift annuity for one of its employees? If so, what are the tax implications?

Yes, a company can establish a gift annuity for an employee. Likewise, an individual can establish a gift annuity for a personal employee – a gardener, for example.

The company, or individual employer, as the case may be, will be entitled to an income tax charitable deduction for the contribution less the present value of the payments.

In the year of the gift annuity, assuming the employer does not retain the right to revoke the employee's payments, the employee will have taxable income (W-2 wages) equal to the present value of the annuity payments, and the company can deduct this amount as employee compensation. The portion of each payment that represents a return of the capital on which the employee has been taxed up front will be tax-free for the duration of life expectancy.

If the employer does retain the right to revoke the employee's payments, the present value of the payments will not be taxed as employee compensation in the year the annuity is established. However, the annuity payments will be taxed entirely as ordinary income. Since the employee was not taxed on any portion of the contribution for the gift annuity, there will be no capital to be returned tax-free. As to the company, in addition to claiming the up-front charitable deduction for the excess of the contribution over the present value of the annuity, it can deduct each year, as employee compensation, the portion of the present value of annuity payments paid to the employee during that year. This is the amount that would have been tax-free if an individual of the same age as the employee had contributed an equivalent amount and named himself or herself as annuitant.

It is important to keep in mind that the tax consequences are different depending on whether an individual establishes a gift annuity for a friend or for an employee. For example, a person who establishes an annuity and names a relative or friend as the annuitant makes a gift to that person of the present value of the payments, which may have to be reported on Form 709, the gift tax return, but the relative's or friend's only taxable income will be the ordinary income portion of the annuity payments. On the other hand, a person who establishes an annuity and names a person in his or her employment as annuitant does not make a gift but rather provides additional compensation that must be reported as such. The only question is whether that compensation (the present value of the payments) is reported in the year the annuity is established or incrementally as payments are received, and the timing, in turn, depends on whether the employer retained the right to revoke those payments.

3. **A donor, who has retained the right to revoke an annuitant's payments, either during life by a written instrument or at death by a will or trust, exercises that right while still living. Is that donor entitled to an income tax deduction?**

At the time the annuity was established, the donor made one completed gift – to the charity for the excess of the contribution over the present value of the payments – and received a charitable deduction for it. The donor did not make a completed gift of the present value of the payments. Upon the exercise of the power of revocation, the donor does make a gift of the present value of those payments, albeit to the charity rather than the annuitant. Since the donor retained within his or her power the right to contribute the annuity interest to the charity at any time, and since he or she would be giving his entire interest in the annuity contract, it would seem that the donor would be entitled to a deduction. The amount of the deduction would be the present value of the payments, calculated as of the date of the revocation.

A counter argument would be that no charitable deduction should be allowed because the donor is giving up nothing of personal value. No action by the donor could have redirected the payments to himself or herself, for the right to those payments had been forfeited in the contract. If the donor is not impoverished by the transaction, then, arguably, no gift has been made.

In the absence of regulations or rulings directly on point, we may consider further whether the exercise of the power of revocation meets the definition of a gift. Rev. Rul. 86-63 states: "A contribution for purposes of section 170 of the Code is a voluntary transfer of money or property that is made with no expectation of procuring financial benefit commensurate with the amount of the transfer." The key question is whether a transfer of property is occurring. One answer is "no" because the donor has nothing of material value to himself or herself to convey. Another answer is "yes" because, by the retention of the power of revocation, the donor retained effective control over a "property" (i.e., the right to annuity payments), that property has measurable monetary value, and the relinquishment of it in favor of the charity is a voluntary act. While "fairness" is not necessarily a compelling argument, it does seem fair and according to the intent of the law to allow a deduction for a voluntary conveyance to a charity of something of real value.

4. **Can a non-donor annuitant assign his or her annuity interest to the charity, if the donor has retained the right to revoke the annuitant's annuity interest? If such an assignment is possible, is a charitable deduction allowed and, if so, who would be entitled to it, the donor or the annuitant?**

The annuitant is entitled to the payments so long as the power of revocation is not exercised, and he or she may convey to the charity the contingent right to the payments. The charity, then freed from any future payment obligation, would be free to use the reserves held for the annuity. The donor is powerless to prevent this outcome, and, at most, is merely able to bring about the same outcome by exercising the right of revocation immediately after the assignment.

In this case, it would seem that neither the annuitant nor the donor would be entitled to a charitable deduction. The annuitant's annuity interest really has no value because it could be terminated at any moment. The annuity interest would have to be appraised (by a qualified appraiser and reported on Form

8283) if it is worth more than $5,000, and an appraiser could not justify any value when the payments are subject to termination at the whim of the donor. If the donor were first to execute a document forfeiting any right of revocation, the annuitant would be entitled to a charitable deduction upon the assignment. Of course, at that point the donor would have made a gift to the annuitant of the present value of the annuity payments, which may necessitate filing a gift tax return, Form 709.

Unlike the previous scenario where the donor voluntarily exercised a power conveying valuable property to the charity, the donor is not a party in the decision to make an additional gift to the charity. Since there is no "voluntary transfer of money or property" the definition of a charitable gift is not met.

5. May a charity establish a gift annuity for a person with assets that were granted to the charity from that person's donor advised fund?

It is surprising that this question even arises because the answer is so obvious, but the frequency with which it is asked suggests that in some instances gift annuities may, in fact, have been established with grants from donor advised funds. Money in a donor advised fund belongs entirely to the community foundation or other charity that maintains the fund. No part of that money can be used for the benefit of the donor or an individual selected by the donor. That would be private inurement, which is prohibited. The money never would have landed in the donor advised fund in the first place unless the donor had relinquished all control.

6. Real estate is contributed for a gift annuity and sold soon afterwards. Is the annuity payment based on the net sales proceeds or on the appraised fair market value? Is the answer the same for the charitable deduction?

The gift annuity payment can be any amount mutually agreed by the donor and the charity subject to two conditions: (1) The payment must result in the present value of the annuity being less than 90 percent of the value of the property transferred; otherwise the gift annuity may be subject to unrelated business taxable income. (See IRC Sec. 501(m) and 514(c)(5)). (2) If the annuity is issued in a regulated state to which the charity has submitted a schedule of rates, it cannot vary from those rates, except to offer a lower rate pursuant to the donor's knowledge and consent.

Fearing that the net sales proceeds may be substantially less than the appraised value, some charities offer to pay an annuity equal to the published rate for a person of the annuitant's age multiplied by the net sales proceeds. Sometimes they delay executing the gift annuity agreement until the property is sold, and they indicate on Schedule A of the gift annuity agreement that the value of the property contributed was the net sales proceeds. In an IRS audit, it may appear that the donor sold the property, with the charity acting as agent, and then contributed the net proceeds. If that were the conclusion, the charitable deduction would stand, but the donor might be taxed on all of the capital gain in the property in the year it was sold.

The safest way to proceed is to make a conservative estimate of the net proceeds to be realized and offer a gift annuity rate equal to

$$\frac{\text{estimated net proceeds}}{\text{appraised value}} \times \text{normal gift annuity rate}$$

This results in discounting the gift annuity rate, and, of course, the donor should consent to the discount through some written instrument. It is the rate, not the property value, that should be discounted, for the value of the property reported on Schedule A of the gift annuity agreement should be the same as the value determined by the appraisal and entered on Form 8283. The financial consequences to the charity are the same whether the property value is discounted 10 percent of whether the gift annuity rate is discounted 10 percent.

In the event this is a hot property and a sale is expected soon after the transfer, the gift annuity payment might be determined and the gift annuity agreement executed after the sale. This would enable the rate reduction, if any, to be based on the known proceeds rather than on an estimate of them. The effective date of the contract, which is the date of the gift, would be the date the deed to the property was delivered by the donor – assuming that on that date there was a clear understanding between the donor and the charity that the property was being transferred in exchange for a gift annuity.

The charitable deduction is based on the appraised fair market value of the property, using the nearest age of the annuitant and the applicable CMFR (or the CMFR for either of the two preceding months) as of the date the deed is delivered. The date of sale is not the contribution date, nor are the net sales proceeds the contribution amount.

7. A charity, wanting to minimize its risk when accepting real estate for a gift annuity, identifies a willing buyer and then arranges a simultaneous closing. That is, the property is donated and then sold on the same day. What are the possible adverse tax consequences? Can a simultaneous closing be structured in a way that avoids unwelcome tax consequences?

According to Rev. Rul. 78-197, a sale will not be considered prearranged, and the donor will not be taxed on the capital gain, if the charity is under no binding obligation to sell. If the charity, in anticipation of a gift of real estate, talks to prospective buyers, determines that one or more of them is seriously interested, receives the property, and soon thereafter enters into a purchase and sale agreement with one of these buyers, the donor should not be exposed to taxation on the gain because the charity was under no binding obligation to sell at the time of the gift.

Wanting more assurance, the charity might go a step further and enter into an oral agreement to sell for a certain price, continent upon its receiving the property for a gift annuity. Some would say the charity has not gone too far because it has stopped short of a legally enforceable sales agreement (assuming state law does not treat an oral commitment as binding).

Suppose the charity goes still further and actually enters into a written contingent sales agreement with a prospective buyer and possibly opens an escrow account. It could be argued that the donor has not subjected the charity to an obligation to sell, but that the charity, being under no compulsion to do so, has simply made arrangements to sell in the event it receives certain property by gift. This argument might prevail, but certainly the risk level has increased.

Some charities, having entered into a contingent sales agreement, arrange for a simultaneous closing. On the same day, title is transferred to the charity and then to the prospective buyer. To avoid excise tax on both transactions, a charity might have title transferred directly from the donor to the buyer, in which case the charity does not appear on the chain of title. The question is whether a transfer of title directly from the donor to the buyer, if done at the direction of the charity, would be treated as a gift of the property to the charity. In the case of *Guest v. Commissioner* 77TC9 (1981), Temple Emanuel of Yonkers, New York, agreed to accept certain properties from Winston and Lucy Guest, and the Temple instructed them to retain the properties as nominee on its behalf and to have their attorney prepare deeds conveying the property to the purchaser to whom it would later identify. As to whether Mr. and Mrs. Guest made a completed gift of the proceeds from the sale of the properties, the Court said, "We see no difference between the situation where a donee sells a gift prior to actual receipt of it, and, instead of accepting delivery himself, the donee directs that delivery be made to the purchaser."

While agreeing that the direct deeding did not affect the issue of whether a gift of property was made, the Court found that it did affect the timing of the gift. According to the Court, the gift occurred not in year one when Mr. and Mrs. Guest informed the Temple of their intent to make the gift, but rather in year two when delivery was completed. This means that by the time the gift occurred (delivery of deeds to the purchaser) the charity was under a binding obligation. Of course it has, acting in its own volition, bound itself. Would this cause a donor to be construed as having sold the property, using the charity as agent, and contributing the net cash proceeds? Because the risk is substantial, it is probably prudent to avoid simultaneous closings, or even to enter into any contingent purchase agreement in advance of the gift.

There are other, less risky, ways to mitigate the risk when real estate is contributed for a gift annuity. One, as mentioned above, is to offer a discounted gift annuity rate. Another is to do advance marketing, stopping short of an actual purchase agreement. Another is to have the donor delay payments for a year or so to allow time for a sale. Still another is to identify a potential buyer and enter into "put" agreement that would state that if the charity receives a gift of "x" property, it has a period of "y" days to require the buyer to purchase the property based on certain terms and conditions, which would then be set forth. This appears to satisfy the conditions of Rev. Rul. 78-197 because the charity has the right to compel a purchase, but it is under no obligation to exercise the "put."

8. During the deferral period associated with a standard deferred gift annuity (as opposed to a flexible deferred gift annuity), can the annuitant extend the deferral period, or do payments have to begin on schedule?

The flexible deferred gift annuity was first approved in Private Letter Ruling 9743054. It was reassuring to see in Private Letter Ruling 200449033, issued last year, that the position of the IRS had not changed. In both cases, the IRS ruled that the flexible deferred gift annuity met the requirements of a gift annuity and that the charity would have no unrelated business taxable income.

The two rulings addressed situations where the gift annuity agreement expressly permitted the annuitant to elect the commencement date of payments within a stated period. Whether the IRS would approve extending the commencement date of a deferred gift annuity when the agreement contains no authorizing language is uncertain. In earlier Private Letter Rulings (9017071 and 9042043) the IRS permitted modifications of payment amounts so long as the actuarial value of those modified payments did not exceed the original actuarial value, but again the enabling language was in the contract. Absent such language, it is probably prudent to seek a private letter ruling before extending the deferral date and adjusting the payment amount. Extending the deferral date but not increasing the payments is probably less risky, but even in that case the donor may want the reassurance of a private letter ruling.

9. Suppose the IRS issues new return multiple tables based on more current mortality data. Would it then be necessary to recalculate the taxation of payments for all existing deferred gift annuities that have not started making payments?

Yes. The exclusion ratio (tax-free portion of each payment) is based on the return multiple (Table V of Reg. Sec. 1-72-9) in effect at the annuity starting date. IRC Sec. 72(c)(4) says that for purposes of calculating the exclusion ratio, the annuity starting date is "the first day of the first period for which an amount is received as an annuity under the contract." Thus, if the first payment were June 30, 2010, the annuity starting date (in the event payments are quarterly at the end of the period) would be April 1, 2010. Private Letter Ruling 741290510A, a clarification of Private Letter Ruling 7309280510A, supports this analysis. It states, "The exclusion ratio for a donor who enters into a deferred payment gift annuity contract shall be computed at the time payments start based on the life expectancy at the time payments are to commence."

When providing computer-generated tables showing how deferred gift annuity payments will be taxed, it is advisable to include a caveat stating that, even though the amount of payments will remain constant, how they are taxed will be different from the attached schedule if IRS life expectancy tables change before payments begin. This may well happen because the return multiple tables presently in use are based on outdated mortality data. If it does, charities and administrators should be prepared to do recalculations of the taxation of existing deferred annuities from which payments have not yet begun.

It should be noted that there are different mortality tables for different purposes:

- The return multiple tables to determine taxation of gift annuity payments.
- The 1990 CM tables to determine the charitable deduction from gift annuities and other life income plans.
- The Annuity 2000 tables, with adjustments, for determining the gift annuity rates.

- The Annuity 2000 tables, and in some cases earlier annuity tables, to calculate reserves required by regulated states.

10. Typically, gift annuity agreements state that the annuity is non-assignable except to the charity. Could the agreement be drafted such that the annuity is assignable to either an individual or the charity? If this is possible, are there tax implications?

According to Reg. Sec. 1.1011 – 2(a)(4)(ii), if the annuity received in exchange for contributed property "is nonassignable, or is assignable but only to the charitable organization to which the property is sold or exchanged, and if the transferor is the only annuitant or the transferor and a designated survivor annuitant are the only annuitants, any gain on such exchanges is to be reported as provided in example (8) in paragraph (c) of this section." Example (8) illustrates ratable reporting of capital gain over a donor-annuitant's life expectancy.

It is possible to draft the gift annuity agreement so that payments would be assignable to an individual as well as a charity. Even though payments might be assigned to an individual, they would be payable over the lifetime of the individual annuitant named in the agreement. If that person should die after one year, the person to whom payments were assigned would receive nothing more. The annuitant who assigned his annuity interest to another individual would make a gift to that person, which would be subject to the reporting requirements and taxation applicable to any gift.

The major consequence of either (1) making the annuity assignable to individuals as well as the charity or (2) omitting non-assignability language entirely is that the taxable gain in a contribution of appreciated property could not be ratably reported. That gain would all be taxable to the donor in the year of the gift. The benefit of using prototype agreements that contain the language "non-assignable, except that is may be assigned to the Charity" is that one never inadvertently causes up-front recognition of gain. Such language also makes it easy for individuals, who no longer need the payments, to make an additional charitable gift and accelerate the charity's use of reserves held for the annuity obligation.

11. Is it possible for an annuitant to cash out a gift annuity, exchanging life payments for a lump sum?

This should be possible provided the cash settlement does not exceed the present value of the annuity payments determined as of the day of settlement. The annuitant would be exchanging one property right (guaranteed payments for life) for another property right (a cash sum) of equivalent or lesser value. Here, as in the case of the sale of the income interest of a charitable remainder trust, it is advisable to secure an affidavit from a physician certifying that the annuitant has no medical condition that could result in a shorter-than-normal life expectancy.

In certain private letter rulings, dealing with the so-called "college annuity" (PLR 200233023, for example), the IRS did approve an annuity contract under which an annuitant could "sell or assign" his or her annuity interest to the charity "or to a third party in return for a lump sum payment or installment payments over several years." However, in Private Letter Ruling 20015208, concerning the exchange of an income interest in a remainder trust for a gift annuity, the IRS required that any commutation would be prohibited in the gift annuity agreement. Apparently, the IRS was specifically concerned about an indirect conversion of the income interest of the trust to either a lump sum payment or payments for a limited period of time, for in the later private letter ruling dealing with the college annuity, a commutation provision was approved. A cash-out of the annuity would be consistent with that position.

If the annuity had been funded with cash, the amount of the lump sum payment in excess of the unreturned capital would be taxed as ordinary income. If the annuity had been funded with appreciated property and the gain was being ratably reported because the donor was the annuitant, then the lump sum payment would be (1) capital gain to the extent of the capital gain not yet reported, and (2) tax-free return of capital to the extent of the capital (the portion of the cost basis allocated to the present value of the annuity) that had not yet been paid, and (3) the balance would be taxed as ordinary income.

12. A charity finds itself in competition with another charity for a large gift annuity. To match what the other charity is paying, it offers this particular donor a rate 50 basis points higher than it normally pays to persons his age. Is it an acceptable practice to negotiate the rates when necessary?

There are five questions to be considered before offering to pay a higher-than-normal gift annuity rate. The *first* is whether the charity is willing to assume a higher risk. The higher the rate, the lower the residuum realized by the charity, and the greater the probability of exhausting the contribution before the obligation terminates. The *second* is whether the charity would be violating state law in paying a higher rate. If it has obtained a permit to offer gift annuities in a regulated state such as California, and as part of the registration process has submitted the schedule of rates it will offer, it cannot pay a higher rate on a case-by-case basis. Some charities that have done this have gotten in trouble with state authorities. In a state like California where it is necessary to file a copy of every annuity agreement executed, it is a simple matter for an examiner to check whether rates actually paid correspond with the announced rates. (As noted above, the charity can pay a lower rate, if, following disclosure of the published rates, the donor consents in writing to the lower rate.)

A *third* question is whether the higher rate might result in the present value of the annuity being 90 percent or more of the contribution, in which case the charity could have unrelated business taxable income. The *fourth* question is whether a charity is treating annuitants fairly if it pays higher rates selectively. It could also have a public relations problem if one donor, age 75, learns that another donor, age 75, received a higher rate than he did. A *final* question is whether the charity wants to contribute to rate competition and thereby undermine the gift annuity as a means of making a gift.

The ACGA provides the following reasons for having an industry standard:

- Charities can be assured that if they do not exceed these rates they will minimize their financial risk and almost always derive a net benefit from their gift annuity program.

- The ACGA rates have attained credibility with many state insurance departments, so charities that adhere to these rates may find it easier to meet regulatory requirements.

- When charities follow a common standard and don't compete with one another on rates, they encourage donors to view a gift annuity as a philanthropic instrument (rather than just another investment), and to make decisions based on the charities they wish to support.

For all of these reasons, it is advisable to adopt the ACGA rates, which have become the industry standard and not to negotiate higher rates on a case-by-case basis.

13. Could a deferred gift annuity be deferred for a period of less than one year? For example, could a person establish a gift annuity on August 10, 2005, stipulating that the first quarterly payment be made on March 31, 2006 and that thereafter payments be made at the end of each calendar quarter?

According to the IRC Sec. 72(u), which deals with annuity contracts not held by natural persons, the income on the contract is all taxable to the owner unless one of the listed exceptions applies. One of those exceptions is an immediate annuity which means an annuity "(A) which is purchased with a single premium or annuity consideration, (B) the annuity starting date (as defined in subsection (c)(4)) of which commences no later than 1 year from the date of the purchase of the annuity, and (C) which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period." By this definition, a gift annuity is not a deferred gift annuity unless payments begin more than one year after the contribution date. Thus, an annuity with quarterly payments is not a deferred gift annuity if the contribution is on August 10, 2005 and the first payment is on March 31, 2006. However, there is no legal reason why the first quarterly payment could not be made six months or nine months after the date the annuity was established and funded.

The problem is that existing planned giving software does not accommodate such a scenario. That is because Schedule K, which adjusts the return multiple, providing three numbers for quarterly payments, six for semiannual payments, and twelve for annual payments, does not tell us how to adjust that multiple for quarterly payments delayed more than three months. The software could be modified to provide the correct multiple, possibly by adding the factors together. There are instances when it makes sense to give the charity a few extra months (possibly to consummate a sale) before payments begin. Assuming the deferral period is longer than one payment period – for example, the first quarter payment made nine months after the contribution date, there could be a slight increase in the immediate gift annuity rate to take into consideration interest earned during the deferral period beyond the normal first quarterly payment date.

14. Is it possible to execute a single gift annuity agreement when contributions for the annuity are received on different dates?

This can happen when a donor transfers shares from different mutual funds. For example, shares from Fund A might be transferred to the charity's account on August 1, shares from Fund B on August 3, and funds from Fund C on August 5.

The charity could, of course, execute three different annuity agreements, one for each transfer of shares. However, the charity may not wish to do this because it entails extra paperwork and because each transfer alone is below the minimum contribution the charity requires for a gift annuity.

One possibility is to insert in the gift annuity agreement the contribution dates. For example: "Charity certifies that the Donor, as evidence of her desire to support the work of the Charity and to make a charitable gift, on August 1, 2005, August 3, 2005, and August 5, 2005 contributed to Charity the property described in Schedule A attached hereto, the combined fair market value of which is $__________, taking into account the fair market value of each contribution on the day it was made."

The agreement could then provide that the first payment be prorated from August 5 to the end of the initial payment period. Alternatively, the agreement could provide that the first payment be the combined prorations from each contribution date, but a proration from the latest contribution date is simpler.

Another possibility would be to have some documentation indicating that the charity will receive and hold the successive contributions as agent for the donor until the donor, presumably on the latest date securities are transferred, authorizes the funding of the gift annuity. In that case the securities would be valued on the date the charity ceases to be agent and funds the annuity. In the other scenario, the securities would be valued on the successive dates as they are transferred into the charity's account. If the charity is acting as the donor's agent, the securities should not be sold until the agency relationship is terminated by an authorization to fund the annuity. In the event there is a very long interval between contribution dates, or there is an age change between those dates, separate agreements should be executed.

15. What are possible and permissible sources of payments to annuitants of an annuity that has run dry?

Even in a financially-sound gift annuity program, a particular annuity may run dry. In other words, the residuum (balance in the account for that annuity) will reach zero before the death of the sole or surviving annuitant. The payments, obviously, must continue for the life of the annuitant(s), and they must come from another source.

This issue will not even arise for charities whose annuities are all unrestricted as to use. Many of them do not do fund accounting – i.e., track the portion of the gift annuity reserve attributable to each annuity. Their only concern is to maintain sufficient reserves to cover all annuity obligations combined. Other charities do fund accounting, and some of their annuities are unrestricted and others restricted. They could use some of the reserves for unrestricted annuities to continue the payments on a failed gift annuity.

The more difficult challenge is to find money to continue the payments, if all of the charity's gift annuities are restricted. To transfer funds from the accounts of annuities for restricted purposes to sustain an annuity for a different restricted purpose would seem to be impermissible under the Uniform Management of Institutional Funds Act (UMIFA). Obviously, a charity could transfer some of its general funds to continue payments, but this will not be a popular solution when the administration has precious little discretionary money at its disposal.

To assume that money will be available when an annuity runs dry, the charity might:

- Assess a modest administration fee against all annuities (50 basis points, for example) and use these fees to build a contingency fund. Of course, fees should be disclosed to donors.

- Require that a certain percentage (for example, five or ten percent) of all gift annuities be for the unrestricted purposes of the charity.

Another possibility is to unitize gift annuities, which means operating the gift annuity reserve fund like a pooled income fund. Under this system, no annuity runs dry unless the entire reserve fund is exhausted. (The charity should seek a legal opinion as to whether this is permissible under UMIFA if the methodology for calculating the residuum is disclosed to the donor.)

16. Does reinsurance of a gift annuity affect the donor's charitable deduction?

The answer depends on whether the charity reinsures per a requirement or agreement to do so. In Private Letter Ruling 8322068, which concerned a situation where a charity was required to reinsure the obligation, a charitable deduction was allowed for the difference between the amount contributed and the reinsurance premium. Reg. Sec. 1.101-2(e)(1)(iii)(b)(1) and (2) states that if an organization is regularly engaged in issuing annuity contracts with an insurance company as the coinsurer or reinsurer of the obligation, the value of the annuity payments is to be determined by use of the discount interest rate and mortality tables used by the insurance company. That value would be the amount of the premium.

Neither the Private Letter Ruling nor the Regulation appears to apply to gift annuities which the charity reinsures at its own discretion. Possibly, the charity reinsures only gift annuities over a certain size, or only a portion of the obligation, and it may decide to reinsure several years after the contract is in force, long after the charitable deduction has been claimed. In all of these cases where the charity reinsures at its discretion, the charitable deduction would be unaffected. As with self-insured gift annuities, the IRS tables and applicable CMFR would be used to determine the value of the annuity.

However, if the gift annuity agreement requires the charity to reinsure, or if the charity has an agreement with an insurance company with which it regularly reinsures all of its annuities, then, based on the Private Letter Ruling and the Regulation, the charitable deduction would be the difference between the contribution and the premium. This would affect the taxation of payments because the capital to be returned tax-free would be the amount of the premium.

17. Sometimes a charity that reinsures a gift annuity prefers to pay a slightly higher premium and purchase from the insurance company an annuity that makes payments for the longer of life or a term certain (10 years for example). Then the charity doesn't leave so much on the table if the annuitant dies prematurely. Is this acceptable?

When legislation was passed shutting down charitable split-dollar life insurance, IRC Sec. 170(f)(1)(D) was included as a safe harbor for the reinsurance of gift annuities. Reinsurance would not be considered an abusive personal benefit contract if certain requirements were met, one of which was that the reinsurance contract would be substantially the same as the gift annuity agreement. Arguably, it is not substantially the same if it provides for payments for the longer of life or a term certain while a gift annuity makes payments for life only. However, there is nothing abusive about the transaction, for the charity is not acting as a conduit for the transfer or purchase of a commercial annuity and any benefits from premature death go to the charity. Thus, it may be unlikely that a reinsurance contract with a term-certain provision would ever be challenged.

18. Is it possible to change the frequency of gift annuity payments, and would doing so affect the amount of the payments.

Changing the payment frequency should be permissible so long as the new schedule of payments does not result in a higher present value of the annuity payments. If payments will be made more frequently (for example, monthly rather than quarterly), the present value will be higher if the total amount paid each full year remains unchanged. This is not permitted because it would result in a smaller charitable deduction than originally claimed. Consequently, when the annuity payments become more frequent, it is necessary to reduce the amount of each payment to ensure the present value of the overall annuity arrangement will remain the same. The adjustment can be made by dividing the present value of a dollar of annuity payment for the less frequent payment schedule by the present value of a dollar of annuity payment for the more frequent payment schedule and multiplying the result by the annual annuity stated in the contract. The present value of a dollar in both instances should be based on the CMFR for the month of the payment-frequency change.

19. If the IRA rollover legislation does not pass, are there ways under existing laws to fund a gift annuity with IRA assets?

In the event the proposed legislation does not become law there are three possible gift arrangements involving IRA assets:

- Withdraw money from the IRA, reserve whatever will be required for tax (including the withholding) and contribute the balance for a gift annuity. The amount of the IRA withdrawal that can be contributed without out-of-pocket cost can be calculated using the following formula:

  $$C = \frac{W(1-R)}{1-RD}, \quad \text{where}$$

  C = contribution for gift annuity,
  W = withdrawal from IRA,
  R = donor's marginal tax rate,
  D = deduction factor (percentage of contribution that is deductible)

  The after-tax cash flow to the donor is actually about the same as from a gift annuity funded with an IRA rollover per the proposed law. However, the charity would realize more because none of the amount taken from the IRA would have to be reserved for taxes.

- Divide an IRA into two IRAs, one equal to the amount that would have been contributed for a gift annuity had the IRA rollover bill been passed. Name the charity as beneficiary of this IRA, and make annual withdrawals equal to the annuity rate that would have been paid.

  The tax consequences will be exactly the same as a gift annuity funded with an IRA rollover. However, the benefit to the charity is less certain because the IRA owner can always change the beneficiary. Also, it will be necessary to coordinate distributions from the charitable and non-charitable IRAs to satisfy mandatory distribution requirements.

- Provide for a testamentary gift annuity with all or a portion of remaining IRA assets.

  This gift arrangement was addressed in PLR 200230018. The most important conclusion in the ruling was that the proceeds payable to the charitable beneficiary will be income in respect of a decedent to the charity under IRC Sec. 691(a)(1)(B) and will not be income in respect of a decedent to the taxpayer's estate. Since the charity is tax-exempt, none of the IRA proceeds will be taxed at the time the annuity is funded. Though the IRS did not rule directly on the matter, it is presumed that payments would be entirely taxable as ordinary income, unless some portion of the IRA was funded with after-tax contributions. Distributions from an IRA left to an heir would likewise have been fully taxable.

A testamentary gift annuity funded with remaining IRA assets could be appealing when:

a) the donor wants to provide fixed, guaranteed payments to a surviving friend or relative and make a charitable gift, or

b) the donor wants to provide for a survivor and make a charitable gift, but the contribution would be too small for a charitable remainder trust to be practical, or

c) the donor wants to assure payments to a surviving spouse for as long as he or she lives without concern that they might cease because of market losses or ever escalating mandatory distributions.

Note: Even if legislation permitting a tax-free rollover does not pass, the growing number of Roth IRAs creates an expanding market for *inter vivos* gift annuities since distributions from such IRAs would not be taxed.

20. Can a non-resident alien establish a gift annuity with an American charity?

Whether the non-resident alien receives any income tax benefit in his or her country of residence depends on the laws of that country and any treaty with the United States.

A Canadian citizen and resident would be entitled to a tax credit if (1) the annuity is established with an American college or university listed on Schedule VIII of the Canadian Regulations, (2) the annuity is established with an American college or university which the donor or a member of his or her immediate family attended, or (3) the Canadian has U.S.-source income. The amount of the donation receipt and the taxation of payments must be determined in accordance with Canadian law. This means that American planned giving software should not be used to compute the donation receipt and taxation of payments. The charity should report to the annuitant and the Canada Revenue Agency (CRA) the taxable portion of annuity payments on Form T4A.

Provided an American charity is authorized to issue gift annuities under its state of domicile, it should be able to issue one to a Canadian donor. It is not known whether provincial insurance departments would try to assert jurisdiction over an American charity that issues gift annuities to their citizens, but American colleges and universities, and other American charities as well, are in fact, receiving gift annuity contributions from Canadians, and their authority to do so has not been questioned by provincial governments.

A charity that issues an annuity to a foreign national sometimes must withhold a percentage of the taxable portion of annuity payments. This percentage varies depending on the country. In the case of Canadian citizens and residents, it is 15 percent. The charity (this time using its American planned giving software to determine the taxable portion of each payment) must withhold 15 percent of that amount and submit it together with completed Form 1042-S.

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